



A REPORT
TO THE
MONTANA
LEGISLATURE

PERFORMANCE AUDIT

*Regulation of
Independent Contractors*

Department of Labor and Industry

MAY 2016

LEGISLATIVE AUDIT
DIVISION

15P-02

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Performance audits conducted by the Legislative Audit Division are designed to assess state government operations. From the audit work, a determination is made as to whether agencies and programs are accomplishing their purposes, and whether they can do so with greater efficiency and economy.

We conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives. Members of the performance audit staff hold degrees in disciplines appropriate to the audit process.

Performance audits are performed at the request of the Legislative Audit Committee which is a bicameral and bipartisan standing committee of the Montana Legislature. The committee consists of six members of the Senate and six members of the House of Representatives.

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May 2016

The Legislative Audit Committee
of the Montana State Legislature:

This is our performance audit of the Regulation of Independent Contractors by the Department of Labor and Industry.

This report provides the legislature with information about the department's regulatory process for designating individuals as independent contractors, including how employer-employee relationships are identified and how misclassification of employees as independent contractors can be identified and prevented. This report includes recommendations for improving detection of employee misclassification by the Department of Labor and Industry. A written response from the Department of Labor and Industry is included at the end of the report.

We wish to express our appreciation to Department of Labor and Industry, Department of Revenue, and Department of Public Health and Human Services personnel for their cooperation and assistance during the audit.

Respectfully submitted,

/s/ Tori Hunthausen

Tori Hunthausen, CPA
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Eric Strauss, Employment Relations Division
Peter Van Nice, Workers' Compensation Regulations Bureau
Sandy Bay, Unemployment Insurance Contributions Bureau

MONTANA LEGISLATIVE AUDIT DIVISION

PERFORMANCE AUDIT
Regulation of Independent Contractors
Department of Labor and Industry

MAY 2016

15P-02

REPORT SUMMARY

Independent contractors are a growing segment of the national workforce and this working arrangement can have many benefits for both individuals and businesses. However, independent contractor status can be abused through misclassification of employees as independent contractors, which can have negative effects on individuals, state revenues and programs, and business competition. The Department of Labor and Industry regulates the independent contractor designation in Montana and can improve its efforts to identify and prevent misclassification of employees as independent contractors.

Context

Most definitions identify independent contractors as individuals who work for themselves. Audit assessment activities found that Department of Labor and Industry (DOLI) has established procedures to implement the Independent Contractor Exemption Certificate and the Contractor Registration programs. Following audit assessment work, we determined further evaluation of DOLI activities to identify and prevent misclassification of employees as independent contractors was warranted.

Businesses that hire independent contractors are not required to have unemployment insurance or workers' compensation insurance for these individuals, and are not required to withhold federal or state taxes. Because of the potential cost savings to businesses that legitimately use independent contractors, there is also a potential that some businesses will inappropriately classify (misclassify) employees as independent contractors. The practice of misclassifying employees as independent contractors can have significant repercussions for state programs, for the competitive marketplace, and for the misclassified employees.

State law includes civil penalties for employers who misclassify employees as independent contractors. DOLI takes its responsibilities in this regard seriously and has successfully prosecuted cases where misclassification has occurred. However, most informed parties also agree that although misclassification can be a serious problem, it is also very difficult to identify, deter, or prevent.

Employee misclassification involves consideration of the complex landscape of modern employment practices in what is often referred to as the 'contingent workforce.' The concept of the contingent workforce includes workers in many different nontraditional roles, such as independent contractors. This report addresses the ability of DOLI to effectively coordinate resources and information used in regulating to the employer-employee relationship, as it relates to independent contractors.

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Results

Identifying and preventing employer misclassification of employees as independent contractors is a difficult endeavor. Other states and the federal government have found that to successfully identify employee misclassification requires improving data analysis and information sharing between programs and levels of government. Our work identified opportunities for DOLI to improve the state's ability to identify situations where employees are being misclassified as independent contractors. In many cases, identifying employee misclassification does not require DOLI to collect more information, but rather share it between programs. Information sharing has proven to be key for numerous other states that have addressed these same issues. The end result for other states has been to focus on increasing access to data and strengthening collaboration within and between state agencies. As a result of this audit, we make three recommendations to DOLI to improve its efforts to identify and prevent misclassification of employees as independent contractors:

- ◆ Integrating existing sources of data within DOLI and implementing analytical methods to identify situations where misclassification may be occurring.
- ◆ Formalizing communications between audit and compliance functions to improve information sharing and enforcement efforts.
- ◆ Ensuring access to more relevant data from other agencies, primarily the Montana Department of Revenue.

Recommendation Concurrence	
Concur	3
Partially Concur	0
Do Not Concur	0
Source: Agency audit response included in final report.	

For a complete copy of the report (15P-02) or for further information, contact the Legislative Audit Division at 406-444-3122; e-mail to lad@mt.gov; or check the web site at <http://leg.mt.gov/audit>

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Chapter I – Introduction and Background

Introduction

Independent contractors are a growing segment of the U.S. work force. Most definitions identify independent contractors as individuals who work for themselves. Instead of working for the same employer all the time, an independent contractor is free to work for any business and choose their own work hours. Independent contractors frequently work on a specific project until it is completed and then move on to another project. Businesses choose to hire independent contractors for a variety of reasons such as adding a specialized skillset to its workforce for a temporary period or providing for flexibility in allocating resources.

The Legislative Audit Committee prioritized a performance audit focusing on the contractor licensing activities at the Department of Labor and Industry (DOLI). Audit assessment activities found that DOLI had established procedures to implement the Independent Contractor Exemption Certificate (ICEC) and the Contractor Registration (CR) programs. Both programs are managed by DOLI's Independent Contractor Central Unit (ICCU), which is a component of the Workers' Compensation Regulations Bureau housed in the Employment Relations Division.

Assessment Work Identified Misclassification as a Risk Area

Following audit assessment work, we determined further evaluation of DOLI's activities to identify and prevent misclassification of employees as independent contractors was warranted. During audit assessment, we found the ICCU had established procedures that allowed ICECs to be provided to individuals who had provided the proper documentation to support independent contractor status. The purpose of the ICEC is to identify individuals who have met defined criteria to be designated as independent contractors. Individuals who work as independent contractors are not classified as employees, and businesses that hire these individuals are not bound by the laws that apply to employees. This means businesses that hire independent contractors are not required to have unemployment insurance or workers' compensation insurance for these individuals. Businesses that use independent contractors are not required to withhold federal or state income taxes, contribute to social security or Medicare, or comply with minimum wage and overtime laws.

Because of the potential cost savings to businesses that legitimately use independent contractors, there is also a potential that some businesses will inappropriately classify (misclassify) employees as independent contractors. The practice of misclassifying employees as independent contractors can have significant repercussions for state and federal revenues, for the competitive marketplace, and for the misclassified employees.

DOLI Efforts to Identify and Prevent Misclassification

No single program or agency within state government is tasked with identifying or preventing employee misclassification, but DOLI has the widest array of programs and tools that can be used to identify employer misclassification of employees as independent contractors. This is particularly true given the department's mission to "promote and protect the well-being of Montana's workers, employers and citizens, and to uphold their rights and responsibilities."

State law includes civil penalties for employers who misclassify employees as independent contractors, which provides a clear indication that the problem of misclassification is both real and considered a regulatory responsibility of the state. DOLI takes its responsibilities in this regard seriously and has successfully prosecuted cases where misclassification has occurred. However, most informed parties also agree that although misclassification can be a serious problem, it is also very difficult to identify, deter, or prevent.

Independent Contractors and the Growth of the Contingent Workforce

Defining the employer-employee relationship involves consideration of a lot of different variables and circumstances specific to a given business. Employee misclassification also involves consideration of the complex landscape of modern employment practices in what is often referred to as the 'contingent workforce.' The concept of the contingent workforce as defined by the federal Department of Labor includes workers in many different nontraditional roles, such as independent contractors, consultants, on-call or on-demand workers, and temporary or seasonal contract or leased workers. Federal Department of Labor analysis of the contingent workforce has identified that these arrangements have many positive benefits for both employers and workers, but they also note that "...contingent arrangements may be introduced simply to reduce the amount of compensation paid by the firm for the same amount and value of work, which raises some serious social questions. This is particularly true because contingent workers are drawn disproportionately from the most vulnerable sectors of the workforce."

Whether defined in positive or negative terms, the contingent workforce is growing. As businesses react to the increasing pressures of global competition through out-sourcing, or adapt its workforce to the needs of just-in-time production models, demand for contingent workers increases. Added to this is evidence that more recent innovations in technology are resulting in business models that rely far less on traditional permanent employees. Sophisticated software and mobile technology platforms are driving growth in businesses that rely on independent contractors more than a traditional employer-employee relationship (and all the rights and responsibilities that go along with it).

This report addresses the ability of DOLI to effectively coordinate resources and information used in regulating to the employer-employee relationship, as it relates to independent contractors. If assumptions about the growth of the contingent workforce are true, regulatory agencies will face increasing demands in this area and will need to develop new strategies to effectively address issues like misclassification of employees as independent contractors. Some of the strategies DOLI could consider are the subject of this report.

Audit Objectives, Scope, and Methodology

Because of concerns raised during audit assessment work, three audit objectives were developed:

1. Is employee misclassification going undetected by state agencies?
2. If employee misclassification is occurring, what is the effect of employee misclassification on state government and the individual?
3. Are there impediments that limit state agencies from identifying and taking action against employers who misclassify employees?

Audit Scope

This audit conducted an analysis of a variety of data sources from DOLI, the Department of Public Health and Human Services (DPHHS), and the Department of Revenue (DOR). This data analysis was not able to specifically identify where businesses had misclassified employees as independent contractors. Instead, this audit identified how various state agencies can compare existing data to identify potential indicators of employee misclassification. Identifying these indicators could allow more effective targeting of limited resources to enforce existing labor laws and collect required revenues/fees that are being avoided by businesses found to be noncompliant.

Although audit activities reviewed data from a variety of state agencies ranging from 2010 through 2015, we focused on calendar year 2013. The reason for focusing on the single year was because one means of identifying employee misclassification is comparing information that is collected by the DOLI and DOR. Because of the schedule for filing personal and business tax forms, 2013 was the most recent complete tax year available to be used in the audit.

Audit Methodologies

To address audit objectives, staff conducted the following work:

- ◆ Interviewed staff at DOLI, DPHHS, and DOR.
- ◆ Reviewed information contained in the DOLI Contractor Registration Independent Contractor Exemption Tracking (CRICET) database.

- ◆ Reviewed information contained in the DPHHS New Hire database.
- ◆ Reviewed information contained in the DOLI Status, Tax Accounting, Audit and Rating System (STAARS) database.
- ◆ Reviewed information contained in the DOLI Workers' Compensation Administration Network (WCAN) database.
- ◆ Reviewed professional and industry publications related to independent contractors and employee misclassification.
- ◆ Contacted staff and reviewed reports from other states to identify activities those states were using to identify employee misclassification.
- ◆ Contacted staff and reviewed reports related to employee misclassification from the U.S. Department of Labor, Government Accountability Office, and the Internal Revenue Service.
- ◆ Evaluated compliance with state law and administrative rules.

Report Contents

Chapter II discusses the prevalence of independent contractors in Montana's economy and some of the potential impacts resulting from misclassification of employees as independent contractors. Chapter III addresses ways identifying employee misclassification can be improved upon.

Chapter II – Independent Contractors in Montana’s Economy

Introduction

Most state programs designed to protect employees and enforce both federal and state employee-related laws are located within the Department of Labor and Industry (DOLI). The DOLI Employment Relations Division is home to the state’s workers’ compensation program, including the Uninsured Employers’ Fund, the Wage and Hour Unit, and the Independent Contractor Central Unit (ICCU). The Unemployment Insurance (UI) program is housed within the Unemployment Insurance Division and includes staff responsible for conducting employer audits to ensure state regulations are enforced.

In many respects, Montana’s system for regulating independent contractors is more advanced than other states. Legislative actions and DOLI programs have developed over the years to provide a strong regulatory framework for identifying individuals operating as independent contractors. These programs are discussed in the following sections, which also address the broader role of independent contractors in Montana’s economy and potential impacts associated with the issue of misclassification of employees as independent contractors.

How Does the DOLI Currently Regulate Independent Contractors?

Under state law, an individual cannot operate as an independent contractor until they have been issued an Independent Contractor Exemption Certificate (ICEC). To be issued an ICEC, applicants must be free from control or direction in work activities and must be engaged in an independent trade or business. Proving engagement in an independent business requires applicants to provide a variety of business-related documents. Proving the applicant is free from control and direction in work activities is accomplished by signing a notarized statement which confirms that as an independent contractor, normal employee-related protections are no longer provided.

The ICCU is staffed with certification and supervisory personnel in Helena and field examiners located around the state. Helena office staff process applications and issue ICECs, while field staff provide education on the requirements for becoming an independent contractor and conduct compliance checks. Supervisory staff will frequently participate in field compliance activities or conduct focused reviews of documentation when potential fraud is suspected. In addition to ICEC issuance,

Helena office and field staff also support the department's Construction Contractor Registration program.

Independent Contractor Exemption Certificate Application Process

When an application for an ICEC is received, DOLI staff confirms that the individual meets the legal definition for the independent contractor designation, which is measured using a point scoring system defined in Administrative Rules. Staff will also ensure the application itself is complete, the signature acknowledging waiver of workers' compensation insurance protections has been notarized, and the required fee of \$125 has been included in the application. If the application is complete, the ICEC will be issued. If the application is incomplete, the applicant will be told how to correct any deficiencies. ICECs are issued for specific occupations and are issued for two years.

Field Compliance Activities

The ICCU field compliance technicians are located in Helena, Butte, Missoula, Billings, Kalispell, and Great Falls. These individuals are involved in the program's efforts to identify noncompliance and public outreach. Noncompliance activities are focused on the construction industry. In that role, field compliance technicians will review local building permits to identify active building projects. Visits are then made to various construction sites to observe activities and ask questions of the prime contractor and any workers on the site. Individuals claiming to be independent contractors are asked to show an ICEC (required to be on their person.) Historically, if the individual was found not to be a registered independent contractor, the individual was provided with a brief explanation of what was entailed and provided with an application.

During a site visit, field technicians also talk to the contractor on site to determine if they are registered with the Contractor Registration (CR) program, also an ICCU responsibility. All businesses working in the construction industry in Montana are required to be registered with the Contractor Registration program. Discussions with ICCU staff indicated there is very limited compliance activity focused outside of the construction industry. Field technicians commented that they will look at other industries only if they receive a tip related to noncompliance, but the primary source of noncompliance has been the construction industry.

How Many Independent Contractors Are There in Montana?

The ICCU uses the Contractor Registration and Independent Contractor Exemption Tracking (CRICET) database to track information from both independent contractor and contractor registration applications. CRICET allows ICCU staff to review current

and historical information about either an ICEC or CR file. Documents included in the ICEC or CR application are scanned and electronically connected to the individual file.

Audit work included review of CRICET data for calendar years 2013 and 2014. As of 2014, there were almost 19,000 individuals included within the CRICET system. Table 1 provides more information on ICEC applications for the 2013-14 period.

As shown in the table, the ICCU is processing almost 10,000 applications annually or an average of roughly 800 per month. Very few ICEC applications are not approved by DOLI, and it takes about two weeks to process an application.

Table 1
Independent Contractor Exemption Certificate
Application Statistics
 Calendar Years 2013 and 2014

	2013	2014
Total Applications Received	9,597	9,817
Approved	9,354	9,469
Not Approved	243	348
Percentage Not Approved	2.6%	3.7%
Average Received Monthly	800	818
Average Processing Time (days)	17.6	16.1

Source: Compiled by the Legislative Audit Division from DOLI records.

Independent Contractors' Role in the Economy

With over 19,000 individuals currently certified by DOLI as independent contractors, this type of business organization obviously plays a significant role in the state's economy. Quantifying the impacts of independent contractors in the economy is more difficult in monetary terms, because DOLI does not collect data on sales, receipts, or income from ICEC applicants. In fact, very little is known nationally about the economic contributions of independent contractors, because there is limited econometric data collected on this specific part of the contingent workforce.

Regulatory and academic studies and analyses of independent contractors often rely on a data series produced by the United States Census Bureau to quantify economic impacts. The Census Bureau annually releases data on nonemployers, which is broadly defined to include businesses that have no paid employees and are subject to federal income tax. In 2013, there were approximately 85,000 businesses in Montana defined as nonemployers and they contributed a total of \$3.4 billion to the state's economy.

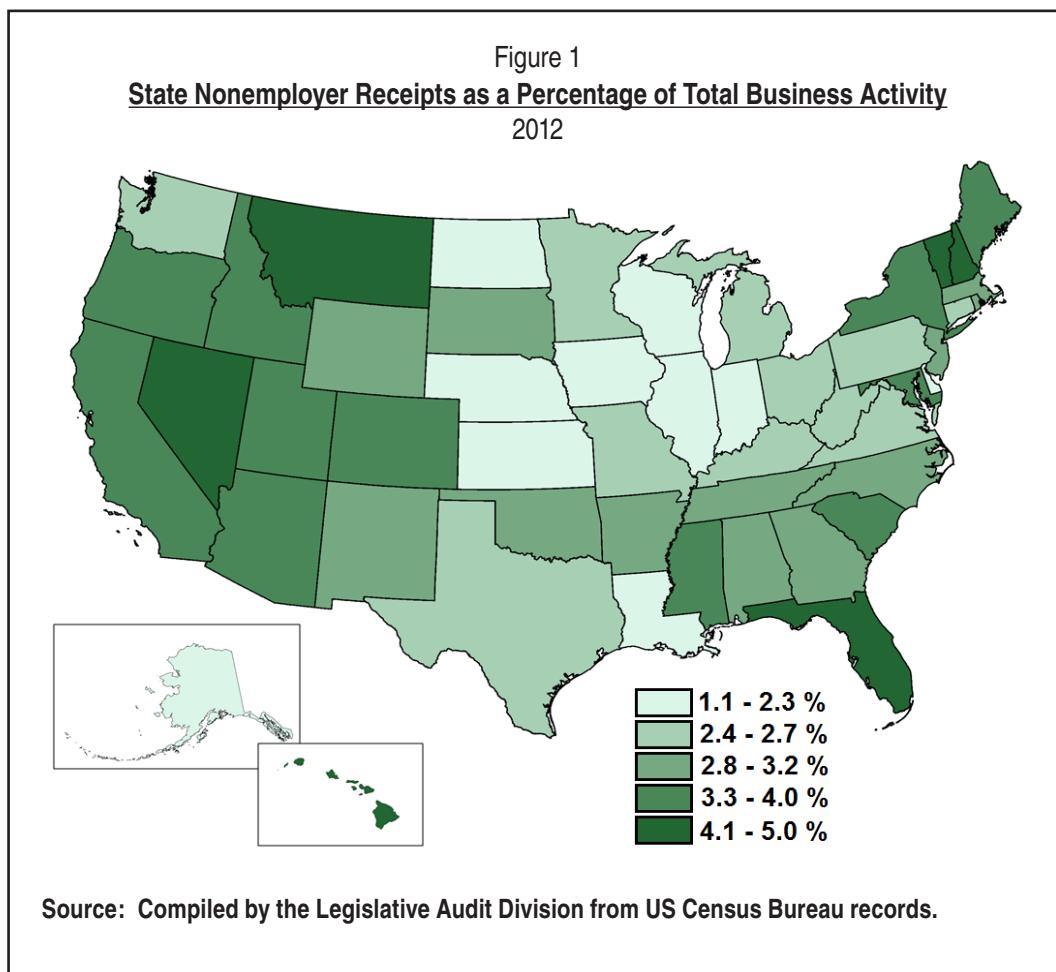
Obviously, there is a disparity between the number of independent contractors regulated by DOLI and the number of nonemployer businesses identified in other economic data. This is because although many independent contractors meet the definition of

a nonemployer business, some do not (because they have paid employees themselves). In addition, the nonemployer statistics include many businesses that would not be required to obtain an ICEC in Montana because they do not ‘contract’ or work for hire, and simply operate as sole proprietorships.

Comparing Montana's Nonemployer Workforce to Other States

Although nonemployer statistics are not an ideal measure of independent contractors' economic significance, they do provide a generalized picture for businesses not covered by unemployment insurance, workers compensation, or other programs associated with traditional employer-employee relationships. They are also especially useful for making comparisons at the state level and identifying states where nontraditional employment and the contingent workforce (including independent contractors) are more prevalent.

The following figure shows nonemployer business activity as a percentage of all state business activity (sales, shipments, receipts, revenues, or business done) for all 50 states as reported in the US Census Bureau Economic Census for 2012.



Although nonemployer business activity is generally less than 5 percent of the total for most states, there is a lot of variation. In the case of Montana, approximately 4.3 percent of all business activity is attributable to the nonemployer segment of the economy, which is relatively high compared to a lot of other states. In fact, Montana ranks 5th in the nation when nonemployer economic activity is measured using this method.

What this analysis should emphasize is that nonemployers in general, and independent contractors in particular, are significantly more prevalent in Montana than most other states. From a policymaker's perspective, this should in turn focus more attention on how these activities are regulated and whether issues, such as misclassification of employees as independent contractors, that have been identified nationally as problematic, are being addressed adequately here.

What Are the Potential Impacts of Misclassifying Employees as Independent Contractors?

As noted previously, misclassification of employees as independent contractors is difficult to identify and prevent. The use of independent contractors can provide significant economic advantages to both workers and employers over traditional employment relationships. The benefits for each party might be different. The worker gets the flexibility of working on a job of choice while the business does not have to permanently increase its workforce. As long as both parties have equal control of potential outcomes, equilibrium exists and both employer and worker can freely choose to participate in the relationship. However, situations can occur where employers gain the economic advantage over the worker. These situations can result in employers exerting undue control over the relationship and coercing the worker into an independent contractor role. Detecting employer coercion is difficult and normally requires coordination between regulatory agencies. Not detecting employer coercion can result in significant repercussions for workers and other businesses in market.

Government Accountability Office Audit Reports Have Identified Misclassification as a Valid Concern

The United States Government Accountability Office (GAO) has released several reports addressing the question of misclassification of employees as independent contractors. These reports have focused on the efforts of federal regulatory agencies to address these issues, but have also documented some of the effects of misclassification on workers and businesses. One of the main conclusions of the GAO reporting is stated as follows:

Misclassification can have a significant impact on federal and state programs, businesses, and misclassified employees. It can reduce revenue that supports

such programs as Social Security, Medicare, unemployment insurance, and workers' compensation. Further, employers with responsible business practices may be undercut by competitors who misclassify employees to reduce their costs, for example, by not paying payroll taxes or providing benefits to workers. Employers may also exploit vulnerable workers, including low-wage workers and immigrants, who are unfamiliar with laws pertaining to employment relationships, including laws designed to protect workers. For example, misclassified workers may not be paid properly for overtime or may not know that their employers are not paying worker's compensation premiums.

Effects at the state level are similar; misclassification of employees as independent contractors can affect state revenues through underreporting of employment income, it reduces participation in and coverage under social insurance programs such as unemployment and workers' compensation insurance, and it can create inequities in competitive markets as some employers reduce costs associated with permanent employees.

Effects on State Tax Revenues

Misclassification affects tax revenues as a result of underreporting of income; when income is reported to taxation authorities by employers, there is less income underreporting and better compliance with tax laws. Both the federal government and the majority of states promote compliance with tax laws through third-party reporting of income by employers. Federal and state tax laws require businesses to withhold estimated taxes from employee paychecks, but not those of independent contractors.

The true extent of any impacts from misclassification on Montana's state tax revenues is currently unknown. There have been no attempts by state agencies here to quantify the potential revenue impacts of misclassifying employees as independent contractors. Revenue or labor departments in other states have made efforts to quantify these impacts. For example, a 2010 report of the Maine Joint Task Force on Employee Misclassification estimated that in the construction industry alone, Maine is losing \$2.6-\$4.3 million per year in revenues. A 2009 report submitted to the Rhode Island General Assembly by the Special Joint Commission to Study the Underground Economy and Employee Misclassification estimated that Rhode Island stood to lose \$12 million in income tax revenues from employee misclassification.

Effects on Unemployment Insurance and Workers' Compensation Systems

The Unemployment Insurance Trust Fund is a joint federal/state partnership designed to provide financial stability for workers who involuntarily find themselves without a job. Unemployment insurance (UI) is funded by a fee levied against each employer

on each employee's annual wages. Because it is an employer-paid insurance program, only employees are eligible for UI benefits. Those individuals who voluntarily become independent contractors are clearly notified of the loss of unemployment insurance eligibility when submitting ICEC application. However, individuals who are misclassified as independent contractors by employers may be unaware of the loss of potential benefits.

In 2010, the federal Department of Labor updated its audit guidance for state UI programs (including Montana's) to specifically address the impacts of misclassification of employees as independent contractors. Advice from the federal agency addressed the issues of misclassification in the following terms:

Worker misclassification impacts the UI program by restricting claimant eligibility for UI benefits and reducing UI employer tax revenue on the unreported wages. For those reasons, worker misclassification detection has been an important focus for the UI audit program.

Like any other pooled or social insurance, the UI system can be affected by decreasing rates of participation. For individuals, the lack of benefit eligibility is the main impact. In cases where an individual has been misclassified as an independent contractor, the individual loses the protection UI benefits offer in the event of unemployment. In situations where employer coercion or deception is involved, the individual may not even be aware the eligibility is lost until a claim is made and denied. Similar concerns apply to workers' compensation insurance, which is designed to provide medical care to workers injured on the job. Premiums for coverage are paid for by employers for the benefit of employees. Independent contractors are not eligible for workers' compensation protections.

Effects on Business Competition

Businesses that misclassify employees as independent contractors significantly reduce business employment costs resulting in a competitive advantage over business rivals. As already mentioned, because independent contractors are not employees, these businesses eliminate the cost of workers' compensation insurance and unemployment insurance for these individuals. In addition, these businesses eliminate the employer's share of social security and Medicare on employee wages. These two taxes add 7.65 percent to labor costs for each employee. Table 2 (see page 12) provides a summary of employee-related costs an employer would incur when compiling with state and federal laws for a carpenter, an accountant, and a personal care aide. These employer cost examples assume an average scenario for both workers' compensation and unemployment insurance costs.

Table 2
Employer Costs for Selected Positions

Occupation	Carpenter	Accountant	Personal Care Aide
Average Annual Wage	\$39,620.00	\$61,100.00	\$21,810.00
Workers' Compensation Premium	\$5,519.07	\$73.32	\$1,371.85
Workers' Compensation Surcharge	\$120.64	\$1.60	\$29.99
Unemployment Insurance Premium	\$1,138.32	\$552.42	\$431.84
Social Security	\$2,456.44	\$3,788.20	\$1,352.22
Medicare	\$574.49	\$885.95	\$316.25
Federal Unemployment Tax Act	\$42.00	\$42.00	\$42.00
Total Employer Cost	\$9,850.96	\$5,343.49	\$3,544.15
Employer Cost Percentage	25%	9%	16%

Source: Compiled by the Legislative Audit Division from Department of Labor and Industry, Montana State Fund, and Department of Revenue records.

As shown, employee costs can be significant for the employer, depending on the potential for workplace accidents and the employer's claims history. Businesses that misclassify employees as independent contractors are able to reduce these costs to \$0.00 and achieve a significant advantage over a competitor who is meeting employer obligations. These kinds of savings to an employer could provide a strong incentive to engage in coercive or deceptive practices that result in actual employees being classified incorrectly as independent contractors. These incentive effects would be especially strong where competitors are abiding by the rules and do incur the costs associated with providing employees the relevant benefits and protections.

What Can Be Done to Prevent Misclassification?

In most cases, an individual's decision to act as independent contractor and forgo the benefits associated with employment is rational, financially beneficial, and voluntary. Montana's regulation of this sector of the workforce has developed to reflect this reality and there are clear guidelines and consistent processes provided through the ICEC application process. But knowing who is an independent contractor is different from knowing who is not. Misclassification involves identifying situations such as:

- ◆ An individual and employer have entered into an arrangement where an ICEC is applied for and obtained, but where the underlying conditions still meet the legal definition of an employer-employee relationship. The arrangement may be financially beneficial to both parties, but the ICEC is obtained through misrepresentation and the employee is still being misclassified.

- ◆ An employer deprives an individual of the benefits and protections associated with employee status by compelling or coercing them to obtain an ICEC through misrepresentation, but continue to control them as an employee.
- ◆ An employer, through deception, maintains control of an employee, but makes none of the applications or payments necessary to benefit from this status (W2 withholding, UI or workers' compensation premiums, etc.) The employee may be unaware of the situation and, because the employee was never required to make an ICEC application, may have no knowledge of the legal definitions that apply.

Given these circumstances, DOLI faces challenges familiar to many regulatory agencies. How do you identify or prevent noncompliance by a minority of individuals/businesses without compromising service and efficiency for those abiding by the rules? For an issue like misclassification, which is admittedly difficult to identify, the department's regulatory authority rests largely on effective deterrence. Our review showed that DOLI relies largely on a reactive process to detect misclassification of employees as independent contractors. Although DOLI will respond to misclassification concerns when identified as a result of audit or complaint activity, its detection capabilities are reduced by a reactive rather than a proactive approach. The next chapter discusses options for DOLI to strengthen these deterrence effects through improved analysis of various data sources and better coordination between different regulatory entities.

Chapter III – Identifying Employee Misclassification

Introduction

As the executive agency with the mission of promoting and protecting the well-being of Montana's workers and employers, it falls to the Department of Labor and Industry (DOLI) to identify and prevent employer misclassification of employees as independent contractors. DOLI has many tools at its disposal to achieve this task. States and the federal government have recognized the negative effects of employee misclassification and are taking a more aggressive stance to identify and prevent such activities and to hold employers responsible.

DOLI is responsible for enforcing employment related laws within the state of Montana. Enforcement of these laws is achieved through the efforts of the Unemployment Insurance (UI) program, the Workers' Compensation (including the Uninsured Employers' Fund), the Wage and Hour Unit, and the Independent Contractor (IC) program. Our work identified opportunities for both DOLI and for other agencies to improve the state's ability to identify situations where employees are being misclassified as independent contractors. In many cases, detecting employee misclassification does not require DOLI to collect more information, but rather share it between programs. Information sharing has proven to be key for numerous other states that have addressed these same issues. The end result for other states has been to focus on increasing access to data and strengthening collaboration within and between state agencies. Our findings broadly address three different areas where the DOLI can improve its efforts:

- ◆ Integrating existing sources of data within the department
- ◆ Formalizing information sharing between audit and compliance functions
- ◆ Ensuring access to more relevant data from other agencies, primarily the Montana Department of Revenue

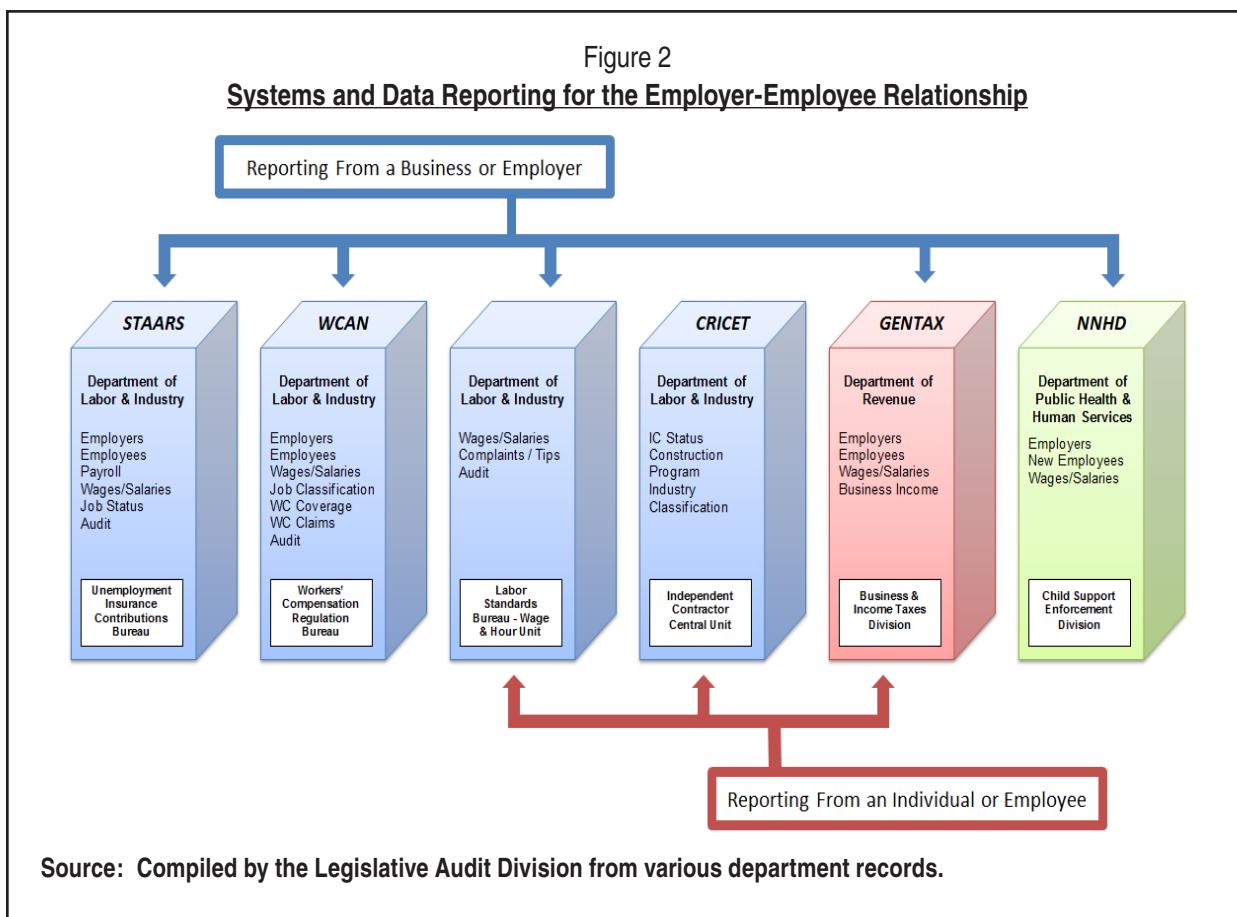
Findings and recommendations addressing these areas are discussed in the following sections.

Integrating Existing Data Sources

As previously discussed, operating as an independent contractor in Montana requires an Independent Contractor Exemption Certificate (ICEC) from DOLI. However, the ICEC can be suspended or revoked if the employer exerts undue control over the working environment or the employer coerces the individual to get the ICEC. Identifying undue control or employer coercion is a difficult task. However, making full use of existing DOLI information systems can help identify potential misclassification.

DOLI and Other Agencies Collect Data Relating to Employer-Employee Relationships

Whether acting as an employer, an employee, or an independent contractor, individuals are required to submit data to DOLI and other state agencies. The data collected by DOLI and other agencies relates to the administration of programs and activities that have been discussed previously in this report (independent contractor status, unemployment insurance, workers' compensation insurance, wage and hour enforcement, income tax withholding, etc.) Much of this data can be linked or related through unique identifiers: social security numbers (SSN) for individuals, or federal employee identification numbers (FEIN) for businesses with employees. The following figure illustrates these data reporting mechanisms for individuals and businesses, and also identifies the agency information systems where different data elements are stored.



Although this illustration does not represent all the reporting between businesses/individuals and state agencies, it includes most of the more significant interactions. As shown, businesses with employees report information to DOLI for the purposes

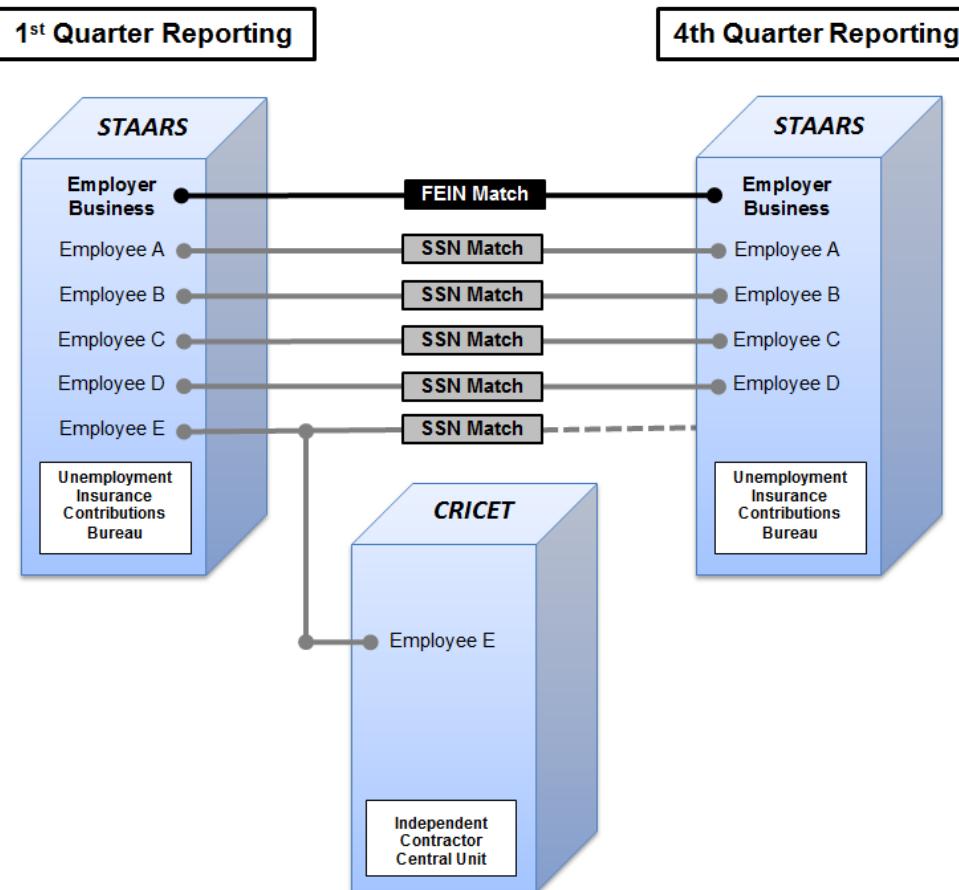
of administering the UI program, providing oversight of the workers' compensation insurance system, and regulating wage and hour laws. Businesses also report information on employees, wages and income to the Department of Revenue (DOR) and the Department of Public Health and Human Services for the purposes of administering the income taxes and enforcing child support laws (this is done through the federal National New Hire Database or NNHD). For individuals or employees, DOLI reporting interactions are related to regulation of wage and hour laws, and the ICEC process. Individuals also report wage/salary and income data to DOR.

Viewed separately and in isolation from each other, these data sources tell us very little about the issue of employee misclassification. As should be expected, each system and the data they contain are currently used primarily in the administration of a particular program or function within DOLI. Because there is no programmatic function within DOLI focused on the issue of employee misclassification, there are currently no mechanisms for analyzing all the department's data to identify these activities.

Implementing an Analytical Approach to Identifying Employee Misclassification

A simple example of using existing DOLI data to identify potential situations where misclassification could be occurring involves data from the STAARS and CRICET systems. STAARS contains data provided by employers used in administering the UI system. CRICET contains data provided by individuals applying for the ICEC. Employers report data on employees in STAARS who are covered under UI. If individuals are being reported as employees in STAARS, but are subsequently dropped from UI coverage and apply for an ICEC, this could indicate a potential misclassification problem. Figure 3 (see page 18) illustrates this scenario.

Figure 3
Data Matching Example to Identify Potential Misclassification



Source: Compiled by the Legislative Audit Division from Department of Labor and Industry records.

In this example, the employer reports five employees in the first quarter of the year for UI coverage. By the end of the year, the fourth quarter reporting shows only four employees, because Employee E is dropped from UI coverage. Within this same time period, matching the SSN for the first quarter employees in the CRICET system identifies that Employee E was issued an ICEC by the IC program. In many situations, identifying this activity would not raise concerns: Employee E simply stopped working for the business and, within the same time period, decided to pursue another line of work and became an independent contractor to do so. However, this activity could also be an indication that misclassification is occurring; the business may have compelled Employee E to accept IC status as a condition of continuing employment.

As part of our work, we analyzed DOLI data using this method to determine whether is it a feasible and practical approach. We reviewed the first and fourth quarters of employer reporting for calendar year 2013 to identify situations where employees were employed in the first quarter by a business, but not in the fourth quarter. This identified over 86,000 individuals, which includes all kinds of different circumstances relating to employment (voluntary or involuntary terminations, retirement, reduction in force, etc.) We then used the employee SSN contained in STAARS to match records within the CRICET system for independent contractors. This process matched 1,242 individuals registered as independent contractors, 513 of whom were issued an ICEC in 2013. Further analysis of other variables such as industry classification, recurring or seasonal employment patterns, or tax reporting (see section below), would help further reduce the number of situations to identify potential misclassification.

Other Examples of Using Data to Identify Potential Misclassification

The example above using STAARS and CRICET data is only one analytical approach DOLI could use to identify potential misclassification. The overall approach addressed here is to analyze data in a manner that identifies different circumstances or variables that may indicate misclassification is occurring. The analytical process uses filtering or elimination to reduce the number of potential employers/employees being identified, enabling more targeted audit or compliance efforts by DOLI. While looking for co-occurring STAARS/CRICET data may help identify misclassification, other uses of these systems could also be identified. Additionally, DOLI could explore other systems and sources, examples of which are discussed as follows:

- ◆ **Uninsured Employers Fund (UEF):** the UEF program provides medical care for employees who experience a workplace injury but whose employer has not provided the required workers' compensation insurance. In 2013, there were 430 employers who failed to provide workers' compensation insurance for employees. Data on workers compensation coverage for employers and employees is maintained in the WCAN system. Currently much of the enforcement effort is focused on ensuring businesses with lapsed policies are not continuing to operate and following up on tips and complaints. Analytical approaches involving cross-matching records in STAARS or CRICET with WCAN are not routinely conducted for the purposes of identifying misclassification.
- ◆ **Wage and Hour Violations:** DOLI's Wage and Hour Unit focuses on activities primarily associated with the Fair Labor Standards Act. All compliance activities are conducted in response to complaints filed with the program. Research on misclassification problems and activities in other states have established links between compliance issues in areas such as wage and hour reporting, and the likelihood an employer will misclassify employees as independent contractors. Reviewing validated wage and hour claims in

conjunction with other compliance data could help DOLI better understand if these patterns exist and could improve enforcement efforts.

- ♦ **National New Hire Database (NNHD):** this federal reporting system is maintained in Montana by the Department of Public Health and Human Services (DPHHS). All employers are required to report data for newly hired employees for the purposes of child support enforcement into the NNHD. Data sharing agreements allow this information to be used by state agencies to identify or prevent fraudulent activities. Identifying employers that report new employees in NNHD, but not in STAARS, could help identify potential cases of misclassification.

Overcoming Barriers to Information Sharing

We tested the approaches discussed above for feasibility and found that in most cases they were practical and realistic methods, even when using a limited number of variables. With appropriate access to the full data sets, DOLI could expand and refine these methods and potentially achieve meaningful results over the long term. Currently, DOLI's use of these or similar analytical approaches are limited and there is a lack of shared query access to multiple DOLI systems that would facilitate analysis of data from different programs. For example, although staff in the UI program can access information for individual independent contractors via CRICET, they do not have query access to the entire data set.

As part of our work, we reviewed efforts in other states to address the issue of misclassification of employees as independent contractors. Washington is an example of a state that has focused efforts on electronic data matching to implement analytical methods for identifying employee misclassification and other issues. In a 2013 benchmarking report on the results of Washington's efforts, the three agencies involved reported roughly 26,000 tips and leads generated through electronic data file transfers. Although Washington's program involves three different agencies and covers more than just employee misclassification issues, it does provide a good indication of the kinds of results that can be achieved through integrating existing sources of data. The Washington State Department of Labor and Industries reported positive results included higher collections of delinquent workers' compensation premiums, improved audit selection, civil and criminal prosecutions, and better compliance with contractor registration requirements.

Implementing this approach would require DOLI to consider issues such as appropriate access rights to certain kinds of data, and protecting sensitive or confidential information, but these are not insurmountable barriers. The department can still maintain effective controls over its data, while ensuring that data is used proactively to provide its various audit or compliance functions with targeted and specific information supplementing the overall enforcement effort. DOLI management also raised concerns regarding

the resources available to conduct this kind of analysis. Depending on the scale of the effort, either additional resources or a redistribution of existing resources may be necessary. Structured analysis of multiple large data sets or systems requires some degree of proficiency in using business intelligence software applications. If DOLI currently has no staff with these skills or cannot access the necessary applications, this could limit its ability to fully implement an analytical approach.

RECOMMENDATION #1

We recommend the Department of Labor and Industry develop procedures to ensure programs conduct frequent and systematic analysis of data to identify anomalies or potential noncompliance relating to misclassification of employees as independent contractors.

Improving Communication Between DOLI Audit and Compliance Functions

Like most state agencies, the organizational structure of DOLI is based on the delivery of specific programs or services. In the context of issues relating to independent contractors, this means that specific programs or bureaus within both the Employment Relations Division and the Unemployment Insurance Division are responsible for administrative and enforcement activities authorized under different sections of state law. These activities typically align with discrete and separate functions, such as collecting UI premiums from businesses, confirming status as an independent contractor, verifying compliance with wage and hour laws, etc. Most of these functional activities also include an audit or compliance capability, either as a separate work group or as part of general program responsibilities. This kind of organizational approach works well for delivering programs or services that are distinct and well-defined, but it poses challenges when dealing with an issue like misclassification of employees as independent contractors. As a compliance issue, there is no specific assignment of responsibility for identifying problems with employees being misclassified as independent contractors. The ICCU can issue or revoke an exemption certificate, but the impacts of misclassification on employees are really more relevant to administration of the UI and workers' compensation systems.

Based on interviews with audit and compliance staff across multiple DOLI work units, we did identify some informal mechanisms for sharing information about issues like misclassification. However, much of this communication was on a case-by-case basis and was typically reactive in nature, i.e. in response to a specific situation. We also

noted differences in the extent and frequency of communication within divisions versus between divisions. Audit and compliance staff within both divisions generally had closer working relationships and more frequent communication when compared with the staffs' interactions with counterparts in other divisions.

Coordinating the Regulatory Response to Misclassification

As part of our work, we reviewed information from 21 states relating to misclassification of employees as independent contractors. This information included various audit and research reports and interviews with responsible officials in some states. These other states showed a broad range of responses to the issue. Some states have taken limited action or are otherwise constrained from doing much to address misclassification. Others, however, have taken more proactive approaches, up to and including forming inter- or intra-agency task forces to coordinate regulatory actions. The California Employment Development Department's joint enforcement efforts are one example of a coordinated regulatory response where different audit and compliance functions within the agency work together to address issues such as misclassification. The Oregon Interagency Compliance Network initiative is another example of a coordinated regulatory response involving audit staff from the state's Employment Department, Bureau of Labor and Industries, and other agencies. These kinds of coordinated responses are credited with improving awareness of issues like misclassification, identifying data sharing strategies, and making more efficient use of enforcement resources.

Within DOLI, we identified a need for better communication between audit and compliance staff across the organization. The current lack of any coordinated analysis of department data is one example of the effects of this lack of communication. Without a means of regularly sharing insights on compliance and enforcement efforts, these kinds of opportunities will continue to be missed. Improving communications would not necessarily have to involve the degree of formality seen in examples from other states. Simple measures such as protocols for sharing tips or leads, email or messaging groups, or periodic meetings between audit and compliance staff from different divisions could all be beneficial.

RECOMMENDATION #2

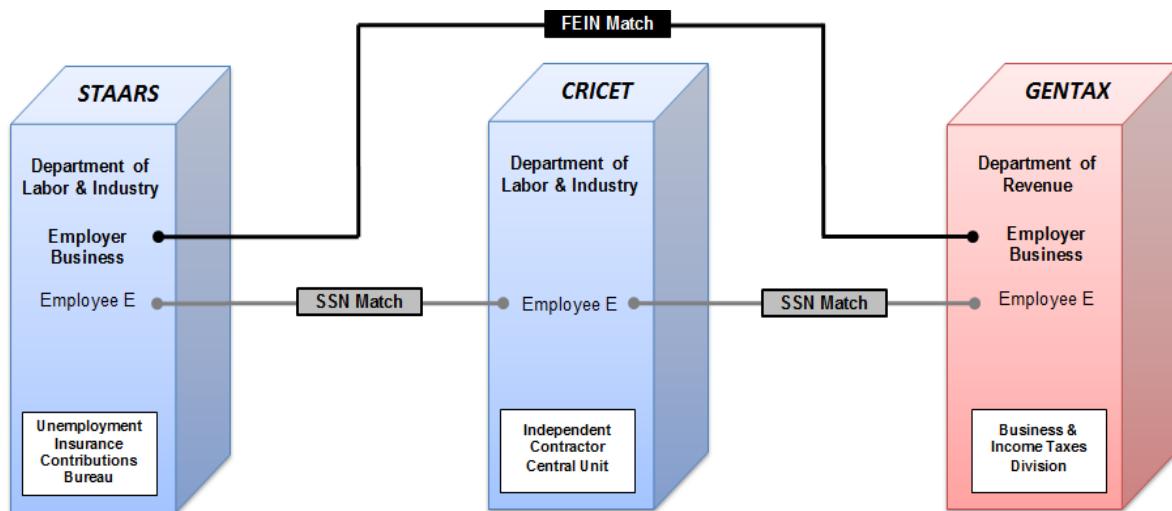
We recommend the Department of Labor and Industry develop processes to provide for regular and structured communication between audit and compliance functions involved in identifying and preventing employee misclassification.

Improving Access to Income Tax Information

States and the federal government have recognized the importance of using individual and business tax information to help identify employee misclassification. DOLI currently accesses tax information directly from the DOR via a Memorandum of Understanding (MOU). The agreement between the two agencies provides some access to some DOR tax records, but we found it has limitations that reduce its usefulness for DOLI.

Under the MOU, DOLI agrees to share quarterly employment data and workers' compensation wage payments to workers with DOR. DOR agrees to provide individual, corporate, and pass-through tax information to DOLI, including 1099-Misc. wage statements. The intended purpose of receiving 1099 wage information is to identify employers who are paying workers as independent contractors rather than employees. Integrating 1099 data in an analysis of misclassification can help establish whether there is an ongoing business relationship between an employer and an individual who is or used to be an employee. Getting access to the right kind of tax data is important if DOLI is to successfully implement analytical review of data that could indicate potential misclassification. The following figure illustrates how 1099 tax data could be used in this kind of analysis.

Figure 4
Integration of Tax Data in Analytical Review



Source: Compiled by the Legislative Audit Division from Department of Labor and Industry and Department of Revenue records.

This example continues with the analytical process discussed earlier in this chapter relating to matching employer and employee data in the STAARS and CRICET systems at DOLI. In this case, Employee E has been identified as being dropped from UI coverage in STAARS prior to being identified as an independent contractor in CRICET. This simple match would likely produce a lot of false positives, as it would include individuals who obtain an ICEC to work in fields/industries that are totally unrelated to the previous UI-covered employment. However, introducing data from the GENTAX system at DOR provides additional context. If an FEIN match for the employer is established between STAARS and GENTAX and the 1099 tax data establishes an ongoing financial relationship between the employer and Employee E, the number of false positives is reduced. Integrating tax data in this kind of analysis could help focus compliance or enforcement efforts through targeted audits of employers.

DOLI Does Not Currently Receive Full Access to DOR Tax Records

The current MOU between DOLI and DOR provides access to 1099-Misc. records, but only for those individuals who have Montana withholdings. The key problem associated with this agreement is that employers issuing 1099-Misc. wage reports to independent contractors do not generally withhold Montana taxes from these payments, which means limited 1099 information is being provided to DOLI. DOLI UI auditors have stated that when they have requested 1099-misc. information on specific businesses, they regularly receive reports of no 1099-misc. being issued. However, when DOLI UI auditors ask the business for the same information during an audit, it is readily available.

The information provided by DOR to DOLI as a result of the MOU has been proven to be incomplete and of little value to DOLI auditors. For example, DOR was asked to provide a list of 1099s issued by employers we identified as part of our analysis of potential misclassification problems. We then compared the identified employers with the data that was available to DOLI under the MOU. There were significant discrepancies between the information we were able to identify and the information that was provided to DOLI. The lack of useful DOR data reduces effectiveness of enforcement efforts and increases the likelihood that employee misclassification will be undetected. In addition, because DOLI was not provided access to appropriate DOR state-collected tax information, the agency is not able to collectively analyze data to identify potential indicators of employee misclassification or fraud/noncompliance with state and federal labor regulations.

Montana Not Participating in Federal Employment Tax Compliance Programs

Another potential means of accessing tax data is through direct cooperation with the federal government. The Questionable Employment Tax Practices (QETP) program is part of the federal government's effort to prevent misclassification of employees. The current program began in 2007 with five states participating. By 2011, 37 states were participating in the initiative. According to a 2011 report on the QETP, the program had resulted in states reclassifying more than \$1.3 billion in wages and had made assessments of \$23 million as a result of information received from the federal government through the QETP program.

According to DOLI officials, the department used to participate in a QETP-like program up until about 1997, but this ended after the UI program was moved from DOR to DOLI in 2004. The reason for the change in status was because the DOLI believed the information flow was from the state to the IRS with limited value being returned to the state. Recent discussions with DOLI officials indicates that the DOLI may revisit its agreement with the IRS in the future, but costs associated to meet data protection requirements were too high at a time when other priorities needed available funding resources. If DOLI were to initiate an agreement with the IRS through the QETP program in the future, it would have access to critical wage information. QETP participation is another common feature in states that are taking a proactive approach to the issue of employee misclassification, but it should be acknowledged that there are potential costs associated with meeting the program's compliance requirements.

DOLI Needs to Access and Use Tax Data More Effectively

Effective integration of state tax data is a common feature in efforts by other states to identify and prevent misclassification of employees as independent contractors. Towards the end of our fieldwork, DOLI was beginning the process of revising its MOU with DOR. Working within the confines of federal laws on accessing tax records, the two agencies should be able to identify how this information can be accessed in a more effective manner. Having access to relevant tax information will in turn assist DOLI in implementing methods to use this data in its efforts to identify misclassification of employees as independent contractors. Reviewing the option of joining the federal QETP program could also provide the DOLI with additional resources that could improve its ability to effectively identify and prevent misclassification of employees as independent contractors.

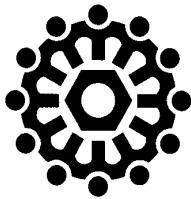
RECOMMENDATION #3

We recommend the Department of Labor and Industry:

- A. *Revise and maintain its memorandum of understanding with the Department of Revenue to provide access to relevant state-collected tax data.*
- B. *Identify and implement processes to integrate tax data in analysis of issues relating to the misclassification of employees as independent contractors.*
- C. *Review its participation in the Questionable Employment Tax Practices program.*

DEPARTMENT OF LABOR
AND INDUSTRY

DEPARTMENT RESPONSE



Montana Department of LABOR & INDUSTRY

Governor Steve Bullock
Commissioner Pam Bucy

Office of Legal Services

May 24, 2016

Ms. Tori Hunthausen
Legislative Auditor, Legislative Audit Division
PO Box 201705
Helena, MT 59620-1705

RECEIVED
MAY 24 2016
LEGISLATIVE AUDIT DIV.

Subject: Performance Audit #15P-02: Regulation of Independent Contractors, DLI

Dear Ms. Hunthausen:

The Department of Labor and Industry has reviewed the May 2016 Report for the Performance Audit of the Independent Contractor Central Unit. The Department would like to thank your audit staff for their review and feedback. As a Department, one of our core values is to look for ways to improve. We appreciate the efforts of others to help assure we are providing quality services with the best accountability possible. Our responses are as follows.

Recommendation #1 – We recommend the Department of Labor and Industry develop procedures to ensure programs conduct frequent and systematic analysis of data to identify anomalies or potential noncompliance relating to misclassification of employees as independent contractors.

Response:

Concur. The Department agrees that potential noncompliance could be identified with systematic data analysis and cross-matches of data. The Department will begin analyzing the best approach to accomplish this function without any further software development. However, fully implementing this recommendation could require significant additional funding and staff resources. For example, there is no current funding for developing software to cross match current databases. Such data analysis must also have safeguards for protecting the confidential information used. The Department will make a determination of what further resources are needed by October 2016.

The Department also notes that at the same time the Audit was conducted, the Independent Contractor Central Unit assessed and changed some of its application procedures to better identify noncompliance issues.

Recommendation #2 – We recommend the Department of Labor and Industry develop processes to provide for regular and structured communication between audit and compliance functions involved in identifying and preventing employee misclassification.

Response:

Concur. The Department currently has quarterly meetings of its various bureaus involved in misclassification issues, on an as needed basis. Cases are informally shared between affected bureaus. These meetings can be structured to meet this recommendation by adding required agenda items that regularly compare audit and compliance misclassification issues. The Department will implement a process to increase communications between audit and compliance functions across the Department by October 2016.

Recommendation #3 – We recommend the Department of Labor and Industry:

- A. Revise and maintain its memorandum of understanding with the Department of Revenue to provide access to relevant state-collected tax data.**

Response:

Concur. The Department recently revised the MOU with the Montana Department of Revenue (DOR) on May 3, 2016. DOR will begin sharing prior year 1099 MISC data compiled for each employer that includes the total number of 1099-MISC issued by FEIN. The Department will analyze this data for use in identifying potentially misclassified workers and better targeting its compliance efforts. The Department will continue to work with DOR in sharing relevant data.

- B. Identify and implement processes to integrate tax data in analysis of issues relating to the misclassification of employees as independent contractors.**

Response:

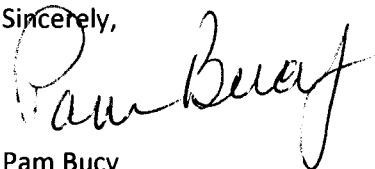
Concur. The Department will assess the resources necessary to develop analytical tools to cross match 1099-MISC data issued to each recipient with the holders of Independent Contractor Exemptions Certificates or other key data. If it is not resource prohibitive, the Department will then pursue amending the MOU with DOR to include the 1099-MISC data for each recipient.

- C. Review its participation in the Questionable Employment Tax Practices Program.**

Response:

Concur. DLI will examine the value of the QETP program for consideration of future participation. As a condition to receiving QETP federal tax information, the Department would need to implement additional federally required safeguards, requiring additional resources and funding.

Sincerely,



Pam Bucy
Commissioner

Cc: Brenda Nordlund, UI Division Administrator
Eric Strauss, ERD Division Administrator